SUPREME COURT, U. S.

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IN THE

Supreme Court of the United States

October Term, 1962.

No. 699

J. W. NEFF AND ELIZABETH A. NEFF,
Petitioners,

v.

THE UNITED STATES.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS.

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IN THE

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No.

J. W. NEFF AND ELIZABETH A. NEFF,
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v.

THE UNITED STATES.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS.

To the Honorable Chief Justice and Associate Justices of the Supreme Court of the United States:

J. W. NEFF and ELIZABETH A. NEFF, by their attorney, respectfully prays that a writ of certiorari issue to review the judgment of the United States Court of Claims, entered July 18, 1962.

OPINIONS BELOW.

The Findings of Fact and original opinion of the Court of Claims, dated April 4, 1962, Judges Durfee and Derr dissenting, is printed at pages 1a to 20a, *infra*, and reported at 301 F. 2d 330. The second opinion dated July 18, 1962, Judge Laramore dissenting, is printed at pages 21a to 32a, *infra*, and reported at 305 F. 2d 455. The order denying plaintiffs' motion for reconsideration or rehearing dated October 3, 1962, Chief Judge Jones and Judge Laramore dissenting is printed at page 33a, *infra*, and not officially reported.

JURISDICTION.

The judgment sought to be reviewed is dated July 18, 1962 which is also the date of its entry. Petitioners' timely filed motion for reconsideration or rehearing was denied October 3, 1962. The jurisdiction of this Court is invoked under Section 1255(1) of the Judicial Code, Title 28 U. S. C.

QUESTION PRESENTED.

In view of the uncontroverted purpose of the acquisition of 47 of its shares of stock by J. W. Neff Laboratories, Inc. from J. W. Neff on September 30, 1954 for $19,035.00 followed by the sale of the bulk of said shares to unrelated parties at substantially increased prices in order to raise needed corporate capital, did such acquisition by said corporation constitute a distribution by it which was essentially equivalent to a dividend or a distribution in full payment in exchange for the stock?

STATUTES AND REGULATIONS INVOLVED.

Internal Revenue Code of 1954, Title 26 United States Code, Section 302. Distributions in Redemption of Stock.

(a) General Rule.—If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

(b) Redemptions Treated as Exchanges.—

(1) Redemptions not equivalent to dividends.—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

(2) Substantially disproportionate redemption of stock.—

(A) In general.—Subsection (a) shall apply if the distribution is substantially disproportionate with respect to the shareholder.

(B) Limitation.—This paragraph shall not apply unless immediately after the redemption the shareholder owns less than 50 percent of the total combined voting power of all classes of stock entitled to vote.

* * *

(5) Application of paragraphs.—In determining whether a redemption meets the requirements of paragraph (1), the fact that such redemption fails to meet the requirements of paragraph (2), (3), or (4) shall not be taken into account.

* * *

Regulations 1.302-1. General.

(a) Under section 302(d), unless otherwise provided in subchapter C, chapter 1 of the Code, a distribution in redemption of stock shall be treated as a distribution of property to which section 301 applies if the distribution is not within any of the provisions of section 302(b). A distribution in redemption of stock shall be considered a distribution in part or full payment in exchange for the stock under section 302(a) provided paragraph (1), (2), (3) or (4) of section 302(b) applies.

* * *

Regulations 1.302-2. Redemptions not taxable as dividends.

(a) The fact that a redemption fails to meet the requirements of paragraph (2), (3) or (4) of section 302(b) shall not be taken into account in determining whether the redemption is not essentially equivalent to a dividend under section 302(b)(1). See, however, paragraph (b) of this section. * * *

* * *

(b) The question whether a distribution in redemption of stock of a shareholder is not essentially equivalent to a dividend under section 302(b)(1) depends upon the facts and circumstances of each case. One of the facts to be considered in making this determination is the constructive stock ownership of such shareholder under section 318(a). All distributions in pro rata redemptions of a part of the stock of a corporation generally will be treated as distributions under section 301 if the corporation has only one class of stock outstanding. However, for distributions in partial liquidation, see section 346. The redemption of all of one class of stock (except section 306 stock) either at one time or in a series of redemptions generally will be considered as a distribution under section 301 if all classes of stock outstanding at the time of the redemption are held in the same proportion. • • •

STATEMENT OF THE CASE.

J. W. Neff Laboratories, Inc. was incorporated in 1938 with an authorized capital of 500 shares of $10.00 par value of which 100 shares were then issued. Plaintiffs subscribed to and purchased 48 shares. Between 1938 and 1954 the only transaction in the company's stock was the purchase in 1949 of 51 shares by plaintiff, J. W. Neff, from the estate of the former controlling stockholder, John Stead.

The company began as a consulting engineering firm which in the post World War II period engaged exclusively in the manufacture of plastic materials, particularly that phase relating to phonograph record compounds. In 1954 it began the manufacture of road marking materials because of the extreme competition which had developed in its major field. Financing of inventory and other phases of the plastic business had been undertaken by Binney & Smith Company late in the 1940's for a commission. By early 1954 Binney & Smith was deeply involved with Laboratories to the extent of about $250,000. It then

decided to disassociate itself with Laboratories on the best terms possible and served an ultimatum on the company. Laboratories attempted to obtain bank financing in vain and ultimately concluded that a sale of stock provided the only practical solution.

Mistaking the 100 shares outstanding as representing 100% of the available stock, Mr. Neff was requested to sell some of his stock to the company so that it could be resold at a higher figure by the company to new shareholders, thus pumping capital into the company. Upon assurances of company counsel that there was no other means of saving the company, he transferred 47 shares to it for $19,035.00 on September 30, 1954. Most of these shares were resold by the company at prices far in excess of its cost, the differential being used to extricate the company from its financial peril. The sole objective of the transaction was to put money into the company for its use, it materially changed plaintiff J. W. Neff's interest in the company to his detriment, and it constituted a distribution in full payment in exchange for the stock.

Jurisdiction over this matter is conferred upon the United States Court of Claims by Title 28, United States Code, section 1346.

SPECIFICATION OF ERROR TO BE URGED.

The Court of Claims not only erred in the application of section 302 of the Internal Revenue Code of 1954 (Title 26, U. S. C.) in the decision of this case but in so doing has placed itself in conflict with other federal courts thereby raising serious questions regarding the application of a key section of the new Internal Revenue Code which affects numerous normal and frequent business transactions.

More specifically, it misapplied a new test imposed by Congress to transactions arising only under section 302(b)(2) of the Internal Revenue Code of 1954 to a case involving only section 302(b)(1) in spite of the fact that section 302(b)(5) provides that the tests under each subsection are mutually exclusive, and in spite of other federal court decisions to the contrary. It also failed to apply the case law of section 115(g)(1) of the Internal Revenue Code of 1939 to its successor section under the 1954 Code, section 302(b)(1), as clearly intended by Congress.

Implicit in the majority opinion and explicit in Judge Whitaker's concurring opinion, which is critical here because of the equal division of the other Judges of the court, is the comparison of the situation on September 30, 1954 *immediately before* and *immediately after* the stock redemption in controversy. Here the court not only fell into reversible error but, even more important to the future administration of the revenue laws, created undesirable confusion and uncertainty regarding the scope of section 302(b)(1). The court's interpretation conflicts with a decision of Court of Appeals for the Eighth Circuit as well as a New York District Court decision.

The immediacy test of subsection (2) has no application to a corporate stock redemption under subsection (1). The alternative application of subsections (1) to (4), in-

clusive, is clearly provided in subsection (5). The Eighth Circuit so held in *United States v. Carey*, 289 F. 2d 531 as did the District Court for the Southern District of New York in *Radnitz v. United States*, 187 F. Supp. 952, 956. Yet the Court of Claims has applied the immediacy test, applicable only to a substantially disproportionate redemption under subsection (2), which was never argued here, to a redemption under subsection (1). It is clear from the legislative history of the section, see Senate Report No. 1622, 83rd Congress, 2nd session discussion of section 301(b), that the law of section 115(g)(1) of the 1939 Code was to be applied to cases arising under section 302(b)(1) of the 1954 Code; the other subsections were *additional areas* in which capital gains treatment of redemptions would be permitted. Thus they were expansive of subsection (1) and not contractive of it.

The court has also failed to perpetuate the 1939 Code law governing stock redemptions as Congress intended. Throughout the majority opinion runs the point that other means could have been used by the corporation to achieve its objective which was the issuance of shares in order to raise badly needed capital. This approach is diametrically opposed to well settled tax law that the tax results of a transaction must be judged by what was done and not by what might have been done. *Higgins v. Smith*, 308 U. S. 473; *Television Industries, Inc. v. Commissioner*, 284 F. 2d 322; *Woodworth v. Commissioner*, 218 F. 2d 719, provided only that the transaction itself was not a sham. No such assertion was made by the government in this case nor would the record support such a contention.

There was no dispute over the facts developed in this case; the sole area of controversy involved the application of the law to the facts. It is here that the court fell into clear error as set out above. This is of importance because the majority opinion unrealistically separated the transaction into artificial compartments involving the re-

demption followed by the resale which does violence to the overall considerations under which the transaction was effected and to the approach of prior case law under this section of the Code. Its alleged justification for this approach is the lack of a prior commitment requiring sale of the redeemed shares. As pointed out in the dissenting opinion, this was commercially unrealistic; more important, however, it fails to adhere to the decisions under the 1939 Code. See *Commissioner v. Snite*, 177 F. 2d 819; *John A. Decker*, 32 T. C. 326, aff'd 286 F. 2d 427; and *Smith v. United States*, 130 F. Supp. 586, as clearly intended by Congress. In S. Rep. No. 1622, *supra* it is stated in this regard:

> "In lieu of the approach in the House bill, your committee intends to revert in part to existing law by making the determination of whether a redemption is taxable as a sale at capital gains rates or as a dividend at ordinary income rates dependent, except where it is specifically provided otherwise, upon a factual inquiry.
>
> • • •
>
> "Paragraph (1) of subsection (b) provides that subsection (a) will apply if the redemption is not essentially equivalent to a dividend.
>
> "The test intended to be incorporated in the interpretation of paragraph (1) is in general that currently employed under section 115(g)(1) of the 1939 Code. Your committee further intends that in applying this test for the future that the inquiry will be devoted safely to the question of whether or not the transaction by its nature may properly be characterized as a sale of stock by the redeeming shareholder to the corporation.

CONCLUSION.

It is respectfully submitted that this Court should grant certiorari herein so that the cloud and uncertainty now hanging over a vital and important section of the revenue laws as a result of the Court of Claims decision may be dispelled.

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APPENDIX TO PETITION.

OPINION OF THE COURT BY LARAMORE, JUDGE; OPINION BY DURFEE, JUDGE, CONCURRING IN PART AND DISSENTING IN PART; OPINION BY DARR, SR. DIST. JUDGE, SITTING BY DESIGNATION, CONCURRING IN THE DISSENT; FINDINGS OF FACT AND CONCLUSION OF LAW.

IN THE

UNITED STATES COURT OF CLAIMS

No. 419-59.

(Decided April 4, 1962.)

J. W. NEFF AND ELIZABETH A. NEFF

v.

UNITED STATES.

NORMAN A. PEIL, JR., for plaintiffs;

EARL L. HUNTINGTON, with whom was ASSISTANT ATTORNEY GENERAL LOUIS F. OBERDORFER, for defendant. JAMES P. GARLAND and PHILIP R. MILLER on the brief.

OPINION.

LARAMORE, *Judge*, delivered the opinion of the court:

This is an action for refund of income taxes in the amount of $8,702 plus interest thereon, paid by plaintiffs as a result of deficiencies assessed. The sole legal issue before us is whether a transaction effecting a redemption of stock by a closely held corporation, as set out below, constituted a distribution essentially equivalent to a dividend, and was

thus taxable to plaintiffs as ordinary income within the purview of section 302 of the Internal Revenue Code of 1954, 26 U. S. C. (I. R. C. 1954) § 302 (1958 ed.), or whether it was a distribution in full payment in exchange for the stock and not so taxable.

J. W. Neff Laboratories, Inc. (hereinafter referred to as the company) was organized and incorporated in Delaware during May 1938. Under the charter 500 shares of $10 par value common stock were authorized, of which 100 shares were issued. Plaintiffs owned 48 of these shares (47 Mr. Neff; and 1 Mrs. Neff).[1] Thereafter during 1938 the com-

(2)

pany was incorporated in Pennsylvania, with authorized capital, stockholders, and distribution of shares remaining identical. The Delaware franchise was subsequently terminated.

No further transactions occurred with respect to company stock until September 1949, when Mr. Neff purchased the 51 shares held by the other major original stockholder from his estate for $14,000. Mr. Neff paid $6,000 of the $14,000 purchase price from his personal funds, and the remaining $8,000 from funds which he borrowed from the company in return for his personal note. After this purchase Mr. Neff owned 99 of the company's 100 outstanding shares.

During September 1950 Mr. Neff borrowed an additional $5,000 from the company for which he again gave his personal note. This brought his total indebtedness on notes payable to the company to $13,000.

Between 1946 and 1954 the company produced material from which phonograph records were fabricated. During

1. Inasmuch as § 318 of the Code attributes these shares to Mr. Neff for all purposes relevant to this proceeding, and since all of the action taken with respect to shares for the purposes of this litigation was taken by Mr. Neff we shall refer to Mr. Neff as holding all of the shares for the remainder of the opinion.

these years the company operated under an arrangement with the Binney & Smith Company whereby Binney & Smith financed certain of the company's operations. By 1954 competition in the phonograph record business had become acute, and profits had diminished. Additional capital was required by the company to embark on a different manufacturing operation.

The testimony indicates that it was ultimately concluded that the most feasible method for raising needed capital was through the local sale of company stock. It was decided that Mr. Neff would sell 47 of his shares to the company. The presence of the 400 authorized but unissued corporate shares was apparent from the readily available basic corporate documents as well as through a simple computation apparent on the face of each stock certificate. Had the company issued new shares to meet its need for additional capital, the result would have been substantially similar. Despite the apparent availability of this alternative course, on September 30, 1954, Mr. Neff transferred 47 shares to the company for $405 per share, or a total of $19,035. At this time book value of the shares was $852.47 per share. The total price of $19,035 was paid by the company by (a) cancellation of the $13,000 in notes payable from Neff to the company; (b) cancellation

(3)

of a loan receivable representing cash advances to Mr. Neff from the company amounting to $776.55; (c) transfer to Mr. Neff of an automobile owned by the company and valued at $2,434.11; and (d) creation of an open account in Mr. Neff's favor on the company books of $2,824.34.

The Government, viewing the transaction as a distribution essentially equivalent to a dividend, and thus subject to tax as ordinary income, assessed a deficiency which plaintiffs have paid. Plaintiffs, in their suit for refund, contend the deficiency assessment was erroneous because the redemption resulted in a corporate distribution which was

payment in exchange for stock held more than six months and thus taxable only under the provisions of the code relating to long-term capital gains.

Plaintiffs' position that the assessment was erroneous is bottomed on two contentions; that the redemption was undertaken exclusively for a valid corporate purpose, to raise corporate capital, and that after the redemption and subsequent to the sale of 38 of the 47 redeemed shares taxpayers' proportionate holding of outstanding company shares had changed radically.

The Government, in countering plaintiffs' contention that the redemption is not essentially equivalent to a dividend, relies on the structure and history of section 302, 26 U. S. C. (I. R. C. 1954) § 302 (1958 ed.). Section 302(a) provides that if a corporation redeems its stock within the meaning of section 317(b), to which the present redemption conforms, and if any one of subparagraphs (1), (2), (3), or (4) of subsection 302(b) applies to the transaction, the redemption will be treated as a distribution in part or full payment in exchange for stock. Subparagraph 302(b)(1) requires that the redemption be treated as a distribution in payment in exchange for stock if it is "not essentially equivalent to a dividend."

We are of the opinion that the transaction in this case was not equivalent to a dividend. The reason we think this is not equivalent to a dividend is that plaintiff was the sole stockholder of the J. W. Neff Laboratories, Inc. This corporation needed additional operating capital. It could not borrow money from the banks; no purchaser would buy stock directly from Mr. Neff since the proceeds of the sale would inure to Neff rather than to the corporation. Hence Mr. Neff

(4)

decided to sell to the company 47 of the 99 shares he owned, at about half of the book value of the shares. This was for the purpose of permitting the corporation to resell these,

which it thought it could do at a profit, and thereby secure the capital necessary to the continuation of the corporation. The corporation did resell 38 shares [2] over a period of between 9 to 12 months, and realized a profit greatly in excess of what the corporation had paid Mr. Neff. The fact that the resale was accomplished over a period of some 9 to 12 months, in our opinion, would not change the complexion of the transaction. Obviously the stock could not be immediately sold at the profit eventually realized. The 9- to 12-month period necessary to complete the transaction should not, and could not, as later demonstrated, alter the situation to the extent of making the sale equivalent to a dividend.

Thus, when the transaction is viewed as a whole, the entire purpose had been accomplished; *i.e.*, the gathering of additional money to sustain the future operations of the corporation. We realize that the presence of a valid business purpose alone is not controlling. *Holsey v. Commissioner*, 258 F. 2d 865, 869; *Northup v. United States*, 240 F. 2d 304, 307. However, in this situation Mr. Neff, after the sale, had a quite different interest than before. This being true, the money and property given him by the corporation in exchange for his stock could not be considered the equivalent of a dividend. When a person receives a dividend, his interest in the company remains exactly the same. This is not the case here. After the entire transaction, Mr. Neff's interest in the company was 56 percent as opposed to his 99 percent stock ownership before.

It is true that section 302(b)(C)(i) contains the language "immediately after the redemption." However, the fact that the stock was sold by the corporation over a period of months would not, in our opinion, have the effect of bringing into play section 302(b)(2) of the 1954 Code. Section 302(b)(1) of the 1954 Code was a re-enactment of section

2. The amount received for the nine shares redeemed by the corporation but unsold was essentially equivalent to a dividend, since plaintiff's interest in the corporation was not reduced. Consequently, plaintiff's claim for capital gains treatment as to these nine shares of stock is without merit.

115(g) of the 1939 Code and reiterated the essential equivalent to a

(5)

dividend test. The prior law on the subject was preserved, as is disclosed by the legislative history of section 301(b)(1).

Senate Report No. 1622, 83rd Congress, 2nd session, in discussing subsection (b) of section 302, states:

> * * * In lieu of the approach in the House bill, your committee intends to revert in part to existing law by making the determination of whether a redemption is taxable as a sale at capital gains rates or as a dividend at ordinary income rates dependent, except where it is specifically provided otherwise, upon a factual inquiry.
>
> * * *
>
> Subsection (b) of Section 302 states three conditions in paragraphs (1), (2), (3) and (4), *the satisfaction of any one of which* will result in the treatment of the redemption as a distribution in full or part payment in exchange for the stock. [Italic supplied.]
>
> * * *
>
> Paragraph (1) of subsection (b) provides that subsection (a) will apply if the redemption is not essentially equivalent to a dividend.
>
> The test intended to be incorporated in the interpretation of paragraph (1) is in general that currently employed under section 115(g)(1) of the 1939 Code. Your committee further intends that in applying this test for the future that the inquiry will be devoted solely to the question of whether or not the transaction by its nature may properly be characterized as a sale of stock by the redeeming shareholder to the corporation. * * *.

From the above language, it seems clear that the tests under the 1939 Code are still pertinent to cases arising

under section 302(b)(1) of the 1954 Code and that the remaining subsections (2), (3), and (4) of said section serve not as restrictions on the scope of subsection (1), but as additional areas in which capital gains treatment will be permitted. This was likewise held in the case of *Radnitz v. United States*, 187 F. Supp. 952, 956.

Having met the test of section 302(b)(1), *i.e.*, that the redemption was not equivalent to a dividend, the intent of Congress as shown by Senate Report No. 1622, *supra*, was that the amount realized on the stock redemption should receive capital gains treatment.

For the above reasons, plaintiffs are entitled to recover and judgment will be entered to that effect.

(6)

The amount of recovery will be determined pursuant to Rule 38(c) of the Rules of this court.

It is so ordered.

WHITAKER, *Judge;* and JONES, *Chief Judge*, concur.

DURFEE, *Judge*, concurring in part and dissenting in part:

I agree with the majority decision as to the corporate distribution for the nine redeemed shares that were never resold by the corporation being essentially equivalent to a dividend. I disagree with the majority in that I believe the corporate distribution for the remaining thirty-eight redeemed shares was also essentially equivalent to a dividend.

As I view the transaction presently before the court the redemption bears no relation whatever to the subsequent change in Neff's proportionate interest in the company. The majority seems to place great emphasis on the assumption that the redemption served a valid business purpose—the acquisition of additional capital. I believe first, that the redemption was unrelated to this purpose, and second, that business purpose is irrelevant inasmuch as under § 302(b)

(1) the net effect of the transaction must be deemed controlling. The net effect of this redemption was the pro rata distribution of $19,035 of the corporation's accumulated earnings and profits.

Once having decided upon the desirability of acquiring additional capital, the most obvious course for the corporation would have been to issue additional corporate shares and have the company sell them. Had thirty-eight additional shares been issued and sold in precisely the same manner as undertaken here, the assets of the company would have remained intact prior to the sale, the total assets would have been enlarged by an identical amount of new capital from the sale, and Neff's proportionate ownership in the corporation would have been altered to a degree substantially equivalent to the change that resulted from the transaction as it actually occurred. Instead the more complex and circuitous redemption procedure was chosen which brought an identical amount of new capital to the company and changed Neff's proportionate interest in the company to essentially the same degree. The only difference between the newly-issued-stock route and the chosen redemption route was that the latter resulted in a $19,035 pro rata distribution out of the company's accumu-

(7)

lated earnings and profits to Neff, who at the time held 99 of 100 corporate shares. In this context the distribution of $19,035 is entirely divested of real relation to the ultimate change in proportionate ownership, and bears every attribute of a dividend.

It appears to me that in reaching a contrary result the majority has overlooked entirely the realities of the closely held—or in this case, single-owner corporation. Presumably had the corporation retired the shares acquired from Neff and then issued new shares for subsequent sale, the majority would have concluded that the distribution was equivalent to a dividend inasmuch as there would have been

no formal connection between redemption and ultimate change in proportionate ownership. I find no greater connection between redemption and ultimate change in proportionate interest in the facts as they actually transpired. It is difficult for me to perceive how, in the context of a company in effect owned, controlled, and directed by one individual, the mere change in wording of the fiat decreed by that single owner should change the tax consequences of the transaction. Moreover, it would seem that the majority decision raises a red flag for alert tax counsel to be on notice that on any occasion that a closely held corporation wishes to acquire additional capital by sale of corporate shares, it may simultaneously return a dividend distribution for its shareholders that will be subject only to capital gains tax treatment, merely by first effecting a pro rata redemption of some of their shares. I do not believe this to be the import of the applicable statutory provisions.

For the reasons stated I must respectfully dissent from the decision of the court.

DARR, *Senior District Judge*, sitting by designation, concurring in the dissent: As I see the case the only applicable statutory provisions are:

Section 302 of the Internal Revenue Code of 1954, 26 U. S. C. § 302.—

> "(a) General rule.—If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraphs (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.
>
> (b) Redemptions treated as exchanges.—
>
> (1) Redemptions not equivalent to dividends.—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.
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> • • •
>
> (5) Application of paragraphs.—In determining whether a redemption meets the requirements

(8)

of paragraph (1), the fact that such paragraph fails to meet the requirements of paragraphs (2), (3), or (4) shall not be taken into account. * * *"

The case will not turn upon the ratio between the number of shares of stock owned by Mr. Neff before the redemption and the number owned thereafter, and also there is out of consideration the language "immediately after the redemption."

The sole question, as I see it, is a factual inquiry as to whether by redemption of the shares of stock Mr. Neff's ownership in the corporation remained the same or was enhanced. This question will turn on whether his remaining shares of stock after the completion of the redemption plan were worth as much or more than the 99 shares of stock were worth before the redemption.

As stated in the majority opinion, immediately before the redemption the corporation needed additional operating capital; could not borrow money from the banks; and no purchaser would buy stock from Mr. Neff. Obviously the stock had no market value before the redemption. The amount paid to Mr. Neff for the stock would not fix the market value. Therefore, the only criterion for the value of the stock is the book value, which was said to be $852.47 per share. However, this includes the $19,035.00 received by Mr. Neff as an asset. Assuming that this amount was a dividend, the book value of each share of the corporation's stock was $662.12. This latter is the proper figure to use in the calculations.

Five months after the redemption, the corporation sold 20 shares of this stock for $2874.00 per share. Between March 21, 1955 and January 11, 1956, 18 more shares were sold as follow:

9 shares	$3569.00 per share
3 shares	3925.00 per share
4 shares	4000.00 per share
2 shares	4250.00 per share

(9)

This makes a total of $125,876 new money coming into the corporation's treasury.

It will not be fair to say that the sale by the corporation set up a market value for the stock, the method would properly be the book value. Before the redemption, the corporation was worth $66,212.00 as reflected by the book value of $662.12 per share. It received $125,876.00 new money from the sale of the stock by the corporation, making the total assets of the corporation $192,088.00 and the book value of the 91 outstanding shares $2103.58 per share.

Before the redemption Mr. Neff's 99 shares, at book value, were worth $65,549.88 and after the completion of the redemption plan his 52 shares, at book value, were worth $109,386.16 The result is that Mr. Neff's remaining 52 shares of stock after the redemption plan was completed were worth $43,836.28 more than his 99 shares of stock before the redemption.[1] It might also be noted that after the redemption plan, Mr. Neff still remained in control of the corporation.

After the redemption plan was completed Mr. Neff's remaining stock was worth substantially more and he was, in addition, $19,035.00 to the good.

Under these facts it seems plain to me that the enrichment of Mr. Neff by the redemption transactions would definitely place the $19,035.00 he received as being essentially equivalent to a dividend.

FINDINGS OF FACT.

The court, having considered the evidence, the report of Trial Commissioner Robert K. McConnaughey, and the briefs and argument of counsel, makes findings of fact as follows:

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1. The calculations do not include the 9 shares of stock in the treasury of the corporation as an asset. If included as an asset in the calculations, Mr. Neff's enrichment was more.

1. Plaintiffs, J. W. Neff and Elizabeth A. Neff, are husband and wife residing at 2121 Edgewood Avenue, Easton, Pennsylvania.

2. Plaintiffs timely filed an individual income tax return on Form 1040, for the calendar year 1954, with the District Director of Internal Revenue at Scranton, Pennsylvania (hereafter referred to as the "District Director"). That

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return did not report the transfer, in 1954, by J. W. Neff to J. W. Neff Laboratories, Inc., for $19,035, of 47 shares of stock in J. W. Neff Laboratories, Inc., or any gain or loss thereon. Mr. Neff explained the failure to report the transaction on the ground that he thought it had not involved any profit.

3. On or about April 23, 1957, following an audit of plaintiffs' 1954 income tax return by an agent of the Internal Revenue Service, plaintiffs filed with the District Director an amended individual income tax return for 1954 on Form 1040. In the amended return, plaintiffs reported $6,133.04 of the $19,035 referred to in finding 2 as a long-term capital gain on assets held for more than 6 months.

4. On or about October 23, 1957, plaintiffs executed and filed a Waiver of Restrictions on Assessment and Collection of Deficiency in Tax, Form 870. Additional income tax of $9,829.98 for 1954 was thereafter assessed and was paid by plaintiffs on November 25, 1957, together with $1,523.65 of interest. The additional assessment was based upon the ground that the $19,035 was essentially equivalent to a taxable dividend and was not, for tax purposes, a sale of a capital asset.

5. On or about May 23, 1958. plaintiffs filed with the District Director, on Form 843, a claim for refund for 1954 of $9,829.98 with interest as provided by law. In the claim for refund, plaintiffs claimed that the purchase of the 47

shares by the J. W. Neff Laboratories, Inc. was motivated solely by business considerations and that the distribution to plaintiff J. W. Neff pursuant thereto was not essentially equivalent to a dividend, but rather was a sale by him of a capital asset held for more than 6 months, and accordingly constituted a capital transaction entitling plaintiffs to long-term capital gain treatment.

6. By registered letter dated January 13, 1959, the Commissioner of Internal Revenue (hereafter referred to as the "Commissioner") notified plaintiffs of the disallowance of $8,702.07 of the claim for refund, and refunded to plaintiffs $1,302.74 with interest thereon of $80.95.

7. J. W. Neff Laboratories, Inc., originally a consulting engineering firm, was incorporated on May 24, 1938, in

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Delaware with an authorized capital of 500 shares of $10 par value common stock. The original stock issued, 100 shares of the 500 authorized, was owned as follows:

Stockholder	*Number of Shares*
John Stead	51
J. W. Neff	47
Elizabeth A. Neff (his wife)	1
C. Oakley McFadden	1
Total	100

8. On December 22, 1938, J. W. Neff Laboratories, Inc. (hereafter sometimes referred to as the "company") was incorporated in Pennsylvania. The authorized capital, the stockholders, and stockholdings in the Pennsylvania corporation remained the same as stated in finding 7 in respect

of the original Delaware corporation. The Delaware franchise was terminated on June 22, 1939.

9. No further transactions in the company's stock occurred until September 1949, when J. W. Neff purchased for $14,000, from the estate of John Stead the 51 shares formerly owned by Mr. Stead. Of the $14,000 purchase price, Mr. Neff paid $6,000 out of his own funds and borrowed the balance of $8,000 from the company, giving his personal note as evidence of the indebtedness. On September 15, 1950, Mr. Neff borrowed an additional $5,000 from the company, bringing his total indebtedness in the form of notes payable to the company to $13,000.

10. After the transaction described in finding 9, the company's stock was owned as follows:

Stockholder	*Number of Shares*
J. W. Neff (President)	98
Elizabeth A. Neff (his wife)	1
C. Oakley McFadden	1
Total	100

11. On September 30, 1954, J. W. Neff transferred 47 of his 98 shares to the company for $19,035, which was paid by (a) cancellation of the $13,000 in notes payable by Mr. Neff to the company, described in finding 9, (b) cancellation of a loan receivable representing cash advances to Mr. Neff totaling $776.55, (c) transfer to Mr. Neff of title to an auto-

mobile owned by the company and valued at $2,434.11, and (d) creation of an open account payable to Mr. Neff in the amount of $2,824.34.

12. The following table shows, for the periods indicated, the company's net profits and the dividends paid:

Year	*Net Profit After Taxes*	*Dividends Paid*
1944	$ 3,817.54	None
1945	* (9,429.00)	None
1946	14,124.42	None
1947	7,650.40	None
1948	16,888.43	None
1949	13,660.18	$3,000
1950	24,893.04	None
1951	3,614.55	None
1952	3,618.55	None
1953	(11,934.83)	None
1954	(11,345.63)	None

* ( ) indicates loss

The 1949 dividend had been required by the executors of the John Stead estate as a condition precedent to the sale of its 51 shares of stock to J. W. Neff, as described in finding 9.

13. About 1946, the company, which formerly had been engaged in designing devices for other companies, decided to engage in the production of phonograph biscuits, (the biscuit shaped lump of material from which phonograph records are made). It did not have adequate financial resources for such a business. Arrangements were made whereby Binney & Smith, Inc., with which the company had previous business contacts agreed to rent the company a building in Stockertown, Pennsylvania and to finance its inventory requirements as well as its invoicing and other operations. For these services, Binney & Smith received a commission. This relationship continued until about 1951, when the company assumed the direct payment of all payroll. Subsequently, the company purchased the Stocker-

town building from Binney & Smith, agreeing to pay the purchase price on an installment basis. Through the entire period from 1946 to late 1954, Binney & Smith financed the company's inventory.

14. Between 1950 and 1954, the phonograph record business (the chief source of the company's sales) was subjected

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to increasingly severe competition and, as shown in finding 12, profits declined.

15. By the beginning of 1954, the company owed Binney & Smith about $250,000, which included the inventory obligation, the unpaid balance on the sale of the Stockertown building, and an amount due on open account. Binney & Smith then decided to terminate, on the best terms possible in the circumstances, the arrangement whereby it was financing the company's inventory.

Various approaches to this problem were considered by Binney & Smith's Board and its legal counsel, including acceptance of stock of the company in part or full payment of the company's debt to Binney & Smith, and placing the company in bankruptcy and obtaining whatever could be salvaged under the hammer.

16. Mr. Neff was informed of Binney & Smith's decision to withdraw from its arrangements for financing the company. In an effort to obtain funds with which to comply with Binney & Smith's demands, and to obtain working capital to be used in part to finance a new venture into the manufacture of road markers, the company attempted unsuccessfully to borrow funds at two banks in Easton, Pennsylvania.

17. The company then proposed to Binney & Smith that its accept company stock in payment for the indebtedness owing to it by the company.

18. About this time, John Schaible, a local acquaintance of Mr. Neff, having learned of the refusal of the banks to lend money to the company, suggested that stock of the company might be sold locally to raise the funds needed. The possibility of a public financing was also discussed. The company's Board of Directors concluded that the only answer to the company's difficulties was the sale of stock locally to raise the money needed for working capital and to repay the obligations owing to Binney & Smith.

19. The company's counsel, who had handled its incorporation in 1938, was consulted. According to Mr. Neff's testimony, he advised that in order to carry out the proposed program, Mr. Neff would have to sell some of his stock to the company so that it would have stock available to sell to others.

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20. Mr. Neff testified that he was reluctant to acquiesce in the proposal that he sell some of his stock because he had faith in the future of the company and desired to participate as fully as possible in its expected growth. According to his testimony, he suggested that if it was necessary for him to part with some of his shares he would prefer to sell them directly to the prospective buyers, but the purchasers opposed this suggestion on the ground that under such an arrangement he, rather than the company, would receive the money, and the purchasers would have no assurance that the funds he received would be placed in the company.

21. Incredible as it may seem, especially in view of Mr. Neff's professed extreme reluctance to part with any of his shares, the uncontradicted evidence in this record is that neither the lawyer who had incorporated the company and had acted as its counsel for the entire period between its organization and the date when it purchased Mr. Neff's stock, nor Mr. Neff, who was one of the incorporators of the company and had been its dominant officer and stock-

holder throughout its history, gave any consideration to the fact that the company already had 500 shares authorized, of which only 100 had been issued. The existence of 400 authorized but unissued shares was evident not only from the basic corporate documents, readily and continuously available to the officers and directors of the corporation and to its counsel, but, through a simple computation, from information stated on the face of each stock certificate. Obviously, the company's need for new capital in 1954 could have been satisfied by the sale of authorized but unissued shares. Even the possible but unnecessary alternative of increasing the authorized capital sufficiently to provide additional shares for direct sale apparently was not considered.

Instead, according to Mr. Neff, he finally was convinced that he had to sell some of his stock to the company if it were to avoid financial ruin, and reluctantly he agreed to do so. It was the choice of this patently unnecessary alternative as a means of providing the company with stock to be sold to procure the funds needed to pay off its obligations to Binney & Smith and to provide it with working capital to finance its venture into the manufacture of road markers, that led to Mr. Neff's transfer of 47 of his 98 shares of the

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company's stock to the company on September 30, 1954, as described in finding 11.

The sale price was $405 per share. The book value per share at the time of sale was $852.47. At the time of the sale, Mr. Neff was receiving an annual salary of $25,000 from the company and an annual salary of $14,487.77 from Binney & Smith. The company automobile was included in the transaction because, according to Mr. Neff, he considered it improper for him to continue to use it as a company automobile with potential new stockholders about to participate in the ownership of the company.

22. On August 31, 1954, the company's checking account contained $9,684.60; on September 30, 1954, it had a balance

of $10,741.23. On both of these dates, the company's ratio of current assets to current liabilities was slightly less than one to one. Its balance sheet, however, showed an earned surplus of $84,247.45, as of September 30, 1954.

23. Between February 24, 1955, and January 11, 1956, the company sold 38 of the 47 shares of treasury stock it acquired through its purchase of Mr. Neff's shares, at varying prices, all much higher than the price it had paid him for the stock. The remainder of the treasury stock was unsold because no buyers could be found. The increased prices at which the treasury stock was sold were said to have been based on a professional appraisal.

24. The following table shows the sales of treasury stock made by the company between February 24, 1955, and January 11, 1956, the dates of sale, the number of shares sold, the sale prices, and the prices per share:

Date of Sale	*Purchaser*	*Number of shares sold*	*Sales price*	*Price per share*
Feb. 24, 1955	Edward R. Schaible	10	$28,740	$2,874
Feb. 24, 1955	William D. Schaible	4	11,496	2,874
Feb. 24, 1955	John F. Schaible	4	11,496	2,874
Feb. 24, 1955	Harry B. Konn	2	5,748	2,874
Mar. 21, 1955	Edgar J. Sales, Sr.	3	10,707	3,569
Apr. 12, 1955	Nathaniel Gravel	1	3,569	3,569
Aug. 17, 1955	S. Donald Avery	5	17,845	3,569
Sept. 6, 1955	William G. Johnson	1	3,569	3,569
Oct. 6, 1955	Rolf E. Johnson	2	7,850	3,925
Dec. 9, 1955	Robert S. Woehrle	1	3,925	3,925
Jan. 11, 1956	John F. Schaible	1	4,000	4,000
Jan. 11, 1956	William D. Schaible	1	4,000	4,000
Jan. 11, 1956	William G. Johnson	2	8,000	4,000
Jan. 11, 1956	William R. Fritz	1	4,250	4,250

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25. As a result of Mr. Neff's transfer of 47 of his shares to the company and the company's subsequent sale of most of these shares to others, Mr. Neff's proportionate interest in the company was, of course, materially changed.

26. Between the date of its incorporation in 1938 and 1954, the company paid no stock dividends and did not split its stock.

27. The company paid no cash dividends during the years 1950 to 1954, inclusive—in the earlier years because it management wanted to retain the earnings in the business, and in the later years because its management believed that in view of its losses in those years, it could not afford to pay cash dividends. In 1955, however, the company earned $32,448.67 after taxes, and paid $11,340 in dividends; and in 1956, it earned $17,905.37 after taxes, and paid $19,110 in dividends.

28. The examination of plaintiffs' 1954 Federal income tax return was conducted early in 1957. By that time, as appears from finding 27, the crisis present in 1954 had passed. When the agent questioned Mr. Neff's treatment of the transaction in his 1954 return, Mr. Neff suggested to the agent that he might reacquire the stock and reassume his stock position with the company as it had existed before the challenged transaction. The record does not disclose the terms on which he proposed to undo the 1954 transaction. Nor does it appear that any such proposal was ever made to the corporation or to the persons who had purchased the stock.

CONCLUSION OF LAW.

Upon the foregoing findings of fact, which are made a part of the judgment herein, the court concludes as a matter of law that plaintiffs are entitled to recover, and judgment will be entered to that effect.

The amount of recovery will be determined pursuant to Rule 38(c) of the Rules of this court.

OPINION OF THE COURT BY DURFEE, JUDGE; CONCURRING OPINION BY WHITAKER, JUDGE; DISSENTING OPINION BY LARAMORE, JUDGE; FINDINGS OF FACT AND CONCLUSION OF LAW.

IN THE

UNITED STATES COURT OF CLAIMS

No. 419-59.

(Decided July 18, 1962.)

J. W. NEFF AND ELIZABETH A. NEFF

v.

THE UNITED STATES.

NORMAN A. PEIL, JR., for plaintiffs;

EARL L. HUNTINGTON, with whom was ASSISTANT ATTORNEY GENERAL LOUIS F. OBERDORFER, for defendant. EDWARD S. SMITH, LYLE M. TURNER, JAMES P. GARLAND and PHILIP R. MILLER on the brief.

OPINION.

DURFEE, *Judge*, delivered the opinion of the court:

This case is now before the court on defendant's motion for reconsideration of our original decision, which was issued April 4, 1962. Plaintiff in this action sought refund of income taxes in the amount of $8,702, paid as a result of deficiencies assessed, and interest thereon.

The sole legal issue before us is whether a transaction effecting a redemption of stock by a closely held corporation, as set out below, constituted a distribution essentially equivalent to a dividend, and was thus taxable to plaintiffs as ordinary income within the purview of section 302 of the Internal Revenue Code of 1954, 26 U. S. C. (I. R. C. 1954) § 302 (1958 ed.), or whether it was a distribution in full payment in exchange for the stock and not so taxable.

J. W. Neff Laboratories, Inc. (hereinafter referred to as the company) was organized and incorporated in Delaware during May 1938. Under the charter 500 shares of $10 par value common stock were authorized, of which 100 shares were issued. Plaintiffs owned 48 of these shares (47 Mr.

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Neff; and 1 Mrs. Neff).[1] Thereafter during 1938 the company was incorporated in Pennsylvania, with authorized capital, stockholders, and distribution of shares remaining identical. The Delaware franchise was subsequently terminated.

No further transactions occurred with respect to company stock until September 1949, when Mr. Neff purchased the 51 shares held by the other major original stockholder from his estate for $14,000. Mr. Neff paid $6,000 of the $14,000 purchase price from his personal funds, and the remaining $8,000 from funds which he borrowed from the company in return for his personal note. After this purchase Mr. Neff owned 99 of the company's 100 outstanding shares.

During September 1950 Mr. Neff borrowed an additional $5,000 from the Company for which he again gave his personal note. This brought his total indebtedness on notes payable to the company to $13,000.

Between 1946 and 1954 the company produced material from which phonograph records were fabricated. During these years the company operated under an arrangement with the Binney & Smith Company whereby Binney & Smith financed certain of the company's operations. By 1954 competition in the phonograph record business had become acute, and profits had diminished. Additional capital was

1. Inasmuch as § 318 of the Code attributes these shares to Mr. Neff for all purposes relevant to this proceeding, and since all of the action taken with respect to shares for the purposes of this litigation was taken by Mr. Neff, we shall refer to Mr. Neff as holding all of the shares for the remainder of the opinion.

required by the company to embark on a different manufacturing operation.

The testimony indicates that it was ultimately concluded that the most feasible method for raising needed capital was through the local sale of company stock. It was decided that Mr. Neff would sell 47 of his shares to the company, which in turn would sell them for its own account and thus acquire additional capital. The presence of the 400 authorized but unissued corporate shares was apparent from the readily available basic corporate documents as well as through a simple computation apparent on the face of each stock certificate. Had the company issued new shares to meet its need for additional capital, the result would have

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been substantially similar. Despite the apparent availability of this alternative course, on September 30, 1954, Mr. Neff transferred 47 shares to the company for $405 per share, or a total of $19,035. At this time book value of the shares was $852.47 per share. The total price of $19,035 was paid by the company by: (a) cancellation of the $13,000 in notes payable from Neff to the company; (b) cancellation of a loan receivable representing cash advances to Mr. Neff from the company amounting to $776.55; (c) transfer to Mr. Neff of an automobile owned by the company and valued at $2,434.11; and (d) creation of an open account in Mr. Neff's favor on the company books of $2,824.34. Thirty-eight of the 47 shares thus redeemed from Mr. Neff were subsequently sold by the company over a period from February 24, 1955 through January 11, 1956 at prices ranging from $2,874 to $4,250 per share.

The Government, viewing the redemption transaction as a distribution essentially equivalent to a dividend, and thus subject to tax as ordinary income, assessed a deficiency which plaintiffs have paid. Plaintiffs, in their suit for refund, contend the deficiency assessment was erroneous be-

cause the redemption resulted in a corporate distribution which was payment in exchange for stock held more than six months and thus taxable only under the provisions of the Code relating to long-term capital gains.

Plaintiffs' position that the assessment was erroneous is bottomed on two contentions; that the redemption was undertaken exclusively for a valid corporate purpose, to raise corporate capital, and that after the redemption and subsequent to the sale of 38 of the 47 redeemed shares taxpayers' proportionate holding of outstanding company shares had changed radically.

The Government, in countering plaintiffs' contention that the redemption was not essentially equivalent to a dividend, relies on the structure and history of section 302, 26 U. S. C. (I. R. C. 1954) § 302 (1958 ed.). Section 302(a) provides that if a corporation redeems its stock within the meaning of section 317(b), to which the present redemption conforms, and if any one of subparagraphs (1), (2), (3), or (4) of subsection 302(b) applies to the transaction, the redemption will be treated as a distribution in part or full payment in exchange

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for stock. Subparagraph 302(b)(1) requires that the redemption be treated as a distribution in payment in exchange for stock if it is "not essentially equivalent to a dividend."

Inasmuch as it seems obvious that the present distribution cannot escape taxation as ordinary income by virtue of any of the specific exculpatory provisions enumerated in subparagraphs (2), (3), and (4) of section 302(b), we shall devote our attention exclusively to the general provision embodied in section 302(b)(1) on which plaintiffs rely.

Section 302(b)(1) of the 1954 Code was essentially a reenactment of section 115(g) of the 1939 Code insofar as it reiterated the broad "essentially equivalent to a dividend" test, and, under § 302(b)(5), was intended to apply regard-

less of the transaction's failure to qualify under any of the specific provisions enumerated in subparagraphs (2), (3), and (4) of § 302(b).[2]

Our task then is to determine whether, on the basis of the facts before us, the transaction by its nature resulted in a distribution essentially equivalent to a dividend.

Even assuming that the sole force motivating the redemption was, as plaintiffs contend, the desire to raise additional capital to support corporate operations, we would view the distribution as one by its nature essentially equivalent to a dividend. Although such motivation would undoubtedly constitute a valid corporate purpose, we do not find the presence of valid corporate purpose dispositive. *Holsey et*

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al. v. Commissioner of Internal Revenue, 258 F. 2d 865, 869 (1958); *Northrup v. United States*, 240 F. 2d 304, 307 (1957). While the absence of any valid corporate purpose

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2. Senate Report No. 1622, 83rd Congress, 2nd session, in discussing subsection (b) of section 302, states:

* * * In lieu of the approach in the House bill, your committee intends to revert in part to existing law by making the determination of whether a redemption is taxable as a sale at capital gains rates or as a dividend at ordinary income rates dependent, except where it is specifically provided otherwise, upon *a factual inquiry*.

* * *

Subsection (b) of Section 302 states three conditions in paragraphs (1), (2), (3) and (4), the satisfaction of any one of which will result in the treatment of the redemption as a distribution in full or part payment in exchange for the stock.

* * *

Paragraph ( ) of subsection (b) provides that subsection (a) will apply if the redemption is not essentially equivalent to a dividend.

The test intended to be incorporated in the interpretation of paragraph (1) is in general that currently employed under section 115(g)(1) of the 1939 Code. Your committee further intends that in applying this test for the future that the *inquiry will be devoted solely to the question of whether or not the transaction by its nature may properly be characterized as a sale of stock by the redeeming shareholder to the corporation.* * * *. (Italics added.)

as motivating the redemption might constitute substantial evidence indicating that the redemption distribution was essentially equivalent to a dividend, we do not believe that the presence of such corporate purpose establishes, *per se*, non-equivalence.

Moreover, while the ultimate sale of the redeemed shares might be deemed related to the corporate purpose of raising additional capital, we find the present redemption itself devoid of any such real relation. Once it had been decided that the corporation required new capital, the most obvious course would have been for the company to issue additional shares and then market the newly-issued shares. Of the 500 shares authorized, only 100 shares had been issued. Had 38 more of the authorized shares been issued and sold in precisely the manner undertaken here, the assets of the company would have remained intact prior to the sale, the total corporate assets would have been incremented by an identical amount of new capital from the sale, and Mr. Neff's proportionate ownership in the corporation would have been altered to a degree substantially similar to the change that resulted from the transaction as it actually transpired. Instead the more complex and circuitous redemption procedure was chosen which brought an identical amount of new capital to the company coffers and changed Mr. Neff's proportionate interest in the company to essentially the same degree. The only difference between the newly-issued-stock procedure and the redemption method selected was that the latter resulted in a $19,035 distribution from the company's accumulated earnings and profits to Mr. Neff, who at that time owned 52 of the 53 outstanding corporate shares. In this context the distribution of $19,035 is entirely divested of any real relation to the ultimate change in proportionate ownership upon sale of the redeemed shares, and bears every attribute of a pro rata corporate distribution constituting a dividend.

In pursuing our factual inquiry into the nature of the present transaction, we deem it both relevant and enlighten-

ing to consider Mr. Neff's essential relation to the corporation. *Commissioner v. Roberts*, 203 F. 2d 304 (CA 4th, 1953). Prior to the redemption Mr. Neff owned 99 percent of the

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corporate shares and assets, and was in effect *the* owner of the corporation and *the* director of its affairs. After the redemption, in addition to the $19,035 distribution he received out of corporate earnings and profits, Mr. Neff owned approximately 98 percent of the outstanding corporate shares and assets (52 of the 53 outstanding shares), virtually the same proportion that he owned before the redemption. No change whatever occurred in Mr. Neff's relation to the corporation until after the corporation began to dispose of the shares it had redeemed, which disposition, as we have indicated earlier, bore no essential relation to the redemption. It is worthy of note that there had been no prior commitment requiring sale of the redeemed shares immediately after the redemption. Had the shares been retired rather than redeemed and had the corporation then issued and sold an equal number of shares, there could be no question that the distribution in payment for the shares would be deemed essentially equivalent to a dividend, inasmuch as there could have been no connection, real or imagined, between redemption and ultimate change in proportionate ownership. We find in the facts as they actually transpired no greater connection between the redemption and ultimate change in proportionate ownership. In the context of a company in effect owned, controlled, and directed by one individual, the mere change in wording of the fiat decreed by that single owner cannot alter the tax consequences of the transaction. The realities of the situation must prevail.

On a more pragmatic level we find it interesting to view the monetary aspects of the present transaction. The book value of the shares at the time of redemption was

$852.47 per share. After reduction of the corporate assets by removal of the $19,035 distributed to Mr. Neff, each corporate share was worth $662.12. The subsequent sale of 38 of the 47 redeemed shares brought a total of $125,876 in new capital to the company treasury. Thus, at the time redeemed, the outstanding shares had a real total value of $66,212, based on a book value of $662.12, After sale of the 38 shares the total assets of the corporation were $192,088, and the book value of each of the 91 outstanding shares was $2,103.58. Thus before the redemption, excluding the $19,035 he withdrew, Mr. Neff's 99 shares had a book value of $65,549.88,

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while after the redemption and sale his 52 shares at book value were presumably worth $109,386.16, or $43,836.28 more than his 99 shares were worth prior to the occurrence of the transactions with which we are concerned. In addition to this monetary accretion in the value of his holding after these events had transpired, Mr. Neff retained control of the corporation as well as the $19,035 distribution.

For the reasons stated we conclude that the distribution of $19,035 to Mr. Neff was one essentially equivalent to a dividend. Consequently we find that it was properly taxed as ordinary income, and that the deficiencies were properly assessed and collected. Our previous opinion, findings of fact and conclusion of law, entered April 4, 1962, will therefore be vacated and withdrawn. This opinion and the findings and conclusion of law which follow will be substituted therefor. Plaintiff's petition will be dismissed.

It is so ordered.

DARR, *Senior District Judge*, sitting by designation; and JONES, *Chief Judge*, concur.

WHITAKER, *Judge*, concurring:

I concurred with Judge Laramore and the Chief Judge in the decision rendered on April 4, 1962, but, on further

reflection, I am convinced that decision was in error. I concurred in the former opinion because I thought we should compare Neff's relationship to the corporation before the redemption with his relationship after all sales of his stock had been made. I am afraid this ignores the provision of section 302, that the comparison must be made between the situation before and "immediately after the redemption."

Besides, it would seem the same result could have been achieved by the sale of the unissued stock of the corporation, as Judge Durfee's opinion states. Had this been done, Mr. Neff would not have benefited to the extent of $19,035, as he did under the plan adopted.

I now concur in Judge Durfee's opinion.

LARAMORE, *Judge*, dissenting:

I am of the opinion that the transaction in this case was not equivalent to a dividend. The reason I think this is not equivalent to a dividend is based on the following: Plaintiff J. W. Neff was the sole stockholder of the J. W. Neff Laboratories, Inc. This corporation needed additional operating capital.

(8)

It could not borrow money from the banks; no purchaser would buy stock directly from Mr. Neff since the proceeds of the sale would inure to Neff rather than to the corporation. Hence, Mr. Neff decided to sell to the company 47 of the 99 shares he owned at about half of the book value of the shares. This was for the purpose of permitting the corporation to resell these, which it thought it could do at a profit, and thereby secure the capital necessary to the continuation of the corporation. The corporation did resell 38 shares over a period of between 9 to 12 months, and realized a profit greatly in excess of what the corporation had paid Mr. Neff. The fact that the resale was accomplished over a period of some 9 to 12 months, in my opinion, would not change the complexion of the transaction. Obviously the

stock could not be immediately sold at the profit eventually realized. The 9- to 12 month period necessary to complete the transaction should not, and could not, as later demonstrated, alter the situation to the extent of making the sale equivalent to a dividend.

Thus, when the transaction is viewed as a whole, the entire purpose had been accomplished; *i.e.*, the gathering of additional money to sustain the future operations of the corporation. I realize that the presence of a valid business purpose alone is not controlling. *Holsey v. Commissioner*, 258 F. 2d 865, 869; *Northup v. United States*, 240 F. 2d 304, 307. However, in this situation, Mr. Neff, after the sale, had a quite different interest than before. This being true, the money and property given him by the corporation in exchange for his stock could not be considered the equivalent of a dividend. When a person receives a dividend, his interest in the company remains exactly the same. This is not the case here. After the entire transaction, Mr. Neff's interest in the company was 56 percent as opposed to his 99 percent stock ownership before.

It is true that section 302(b)(C)(i) contains the language "immediately after the redemption." However, the fact that the stock was sold by the corporation over a period of months would not, in my opinion, have the effect of bringing into play section 302(b)(2) of the 1954 Code. Section 302(b)(1) of the 1954 Code was a re-enactment of section 115(g) of the 1939 Code and reiterated the essential equivalent to a dividend test. The prior law on the subject was preserved,

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as is disclosed by the legislative history of section 301(b)(1).

Senate Report No. 1622, 83rd Congress, 2nd session, in discussing subsection (b) of section 302, states:

> • • • In lieu of the approach in the House bill, your committee intends to revert in part to existing law by

making the determination of whether a redemption is taxable as a sale at capital gains rates or as a dividend at ordinary income rates dependent, except where it is specifically provided otherwise, upon a factual inquiry.

• • •

Subsection (b) of Section 302 states three conditions in paragraphs (1), (2), (3) and (4), *the satisfaction of any one of which* will result in the treatment of the redemption as a distribution in full or part payment in exchange for the stock. [Italic supplied]

• • •

Paragraph (1) of subsection (b) provides that subsection (a) will apply if the redemption is not essentially equivalent to a dividend.

The test intended to be incorporated in the interpretation of paragraph (1) is in general that currently employed under section 115(g)(1) of the 1939 Code. Your committee further intends that in applying this test for the future that the inquiry will be devoted solely to the question of whether or not the transaction by its nature may properly be characterized as a sale of stock by the redeeming shareholder to the corporation. • • •.

From the above language, it seems clear that the tests under the 1939 Code are still pertinent to cases arising under section 302(b)(1) of the 1954 Code and that the remaining subsections (2), (3), and (4) of said section serve not as restrictions on the scope of subsection (1), but as additional areas in which capital gains treatment will be permitted. This was likewise held in the case of *Radnitz v. United States*, 187 F. Supp. 952, 956.

Having met the test of section 302(b)(1), *i.e.*, that the redemption was not equivalent to a dividend, the intent of Congress as shown by Senate Report No. 1622, *supra*, was

that the amount realized on the stock redemption should receive capital gains treatment.

For the above reasons, I believe plaintiffs are entitled to recover in this action.

DAVIS, *Judge*, took no part in the consideration and decision of this case.

(10)

FINDINGS OF FACT

(The Findings of Fact are the same as those in the Opinion of April 4, 1962, printed at pages 11a to 20a, *supra*.)

(17)

CONCLUSION OF LAW

Upon the foregoing findings of fact, which are made a part of the judgment herein, the court concludes as a matter of law that plaintiffs are not entitled to recover, and the petition is, therefore, dismissed.

ORDER OF THE COURT OVERRULING PLAINTIFFS' MOTION FOR RECONSIDERATION OR REHEARING.

IN THE

UNITED STATES COURT OF CLAIMS

No. 419-59.

J. W. NEFF AND ELIZABETH A. NEFF

v.

THE UNITED STATES.

ORDER.

This case comes before the court on plaintiffs' motion for reconsideration or rehearing under Rule 53 of the Rules of this court and on consideration thereof.

IT IS ORDERED this 3rd day of October, 1962, that plaintiffs' motion for reconsideration or rehearing be and the same is overruled.

Judge Laramore dissents for reasons set forth in the dissenting opinion entered herein on July 18, 1962. Chief Judge Jones joins in the dissent.

By THE COURT,

/s/ MARVIN JONES,
Marvin Jones,
Chief Judge.

Senior District Judge Darr sat by designation in the consideration and decision of this case.

Judge Davis took no part in the consideration and decision of this case.

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In the Supreme Court of the United States

OCTOBER TERM, 1962

No. 699

J. W. NEFF AND ELIZABETH A. NEFF, PETITIONERS

v.

THE UNITED STATES

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The first opinion of the Court of Claims (Pet. 1a–11a) is reported at 301 F. 2d 330. The second opinion (Pet. 21a–32a), rendered on respondent's motion for reconsideration, is reported at 305 F. 2d 455.

JURISDICTION

The judgment of the Court of Claims was entered on July 18, 1962. A timely motion for reconsideration or rehearing was denied on October 3, 1962. The petition for a writ of certiorari was filed on December 28, 1962. The jurisdiction of this Court is invoked under 28 U.S.C. 1255(1).

QUESTION PRESENTED

Petitioner, J. W. Neff owned 98 of the 100 shares of outstanding stock of J. W. Neff Laboratories, Inc. The corporation distributed $19,035 to Mr. Neff in redemption of 47 shares of its stock. The question presented is whether the Court of Claims erred in holding that, on the facts of this case, the distribution was "essentially equivalent to a dividend" and therefore taxable as ordinary income rather than capital gain under Section 302 of the Internal Revenue Code of 1954.

STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code of 1954 (26 U.S.C., 1958 ed.):

SEC. 302. DISTRIBUTIONS IN REDEMPTION OF STOCK.

(a) *General Rule.*—If a corporation redeems its stock (within the meaning of section 317 (b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

(b) *Redemptions Treated as Exchanges.*—

(1) *Redemptions not equivalent to dividends.*—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

(2) *Substantially disproportionate redemption of stock.*

(A) *In general.*—Subsection (a) shall apply if the distribution is substantially disproportionate with respect to the shareholder.

* * * * *

(C) *Definitions.*—For purposes of this paragraph, the distribution is substantially disproportionate if—

(i) the ratio which the voting stock of the corporation owned by the shareholder immediately after the redemption bears to all of the voting stock of the corporation at such time.

is less than 80 percent of—

(ii) the ratio which the voting stock of the corporation owned by the shareholder immediately before the redemption bears to all of the voting stock of the corporation at such time.

* * * * *

(5) *Application of paragraphs.*—In determining whether a redemption meets the requirements of paragraph (1), the fact that such redemption fails to meet the requirements of paragraph (2), (3), or (4) shall not be taken into account. * * *

* * * * * *

(d) *Redemptions Treated as Distributions of Property.*—Except as otherwise provided in this subchapter, if a corporation redeems its stock (within the meaning of section 317(b)), and if subsection (a) of this section does not apply, such redemption shall be treated as a distribution of property to which section 301 applies.

* * * * *

Treasury Regulations on Income Tax (1954 Code):

SEC. 1.302–2 *Redemptions not taxable as dividends.*

* * * * *

(b) The question whether a distribution in redemption of stock of a shareholder is not essentially equivalent to a dividend under section 302(b)(1) depends upon the facts and circumstances of each case. One of the facts to be considered in making this determination is the constructive stock ownership of such shareholder under section 318(a). All distributions in pro rata redemptions of a part of the stock of a corporation generally will be treated as distributions under section 301 if the corporation has only one class of stock outstanding. * * *

* * * * *

STATEMENT

J. W. Neff Laboratories, Inc., originally a consulting engineering firm, was incorporated on May 24, 1938, with an authorized capital of 500 shares of $10 par value common stock (Pet. 13a). At the time of the transaction involved here, the company's outstanding stock was owned as follows (Pet. 14a):

	Number of shares
J. W. Neff (President)	98
Elizabeth A. Neff (his wife)	1
C. Oakley McFadden	1
Total	100

On September 30, 1954, Mr. Neff transferred 47 of his 98 shares to the company for $19,035 (Pet. 14a).

During the prior years 1944 through 1954, the only dividend the company had paid was in 1949 (Pet. 15a). For the period 1950 to 1954, inclusive, this was due at first to a desire on the part of management to retain earnings in the business and later because the company had losses and management believed it could not afford to pay cash dividends (Pet. 20a). The company had never paid stock dividends or split its stock (Pet. 20a).

According to Mr. Neff, the redemption resulted from his reluctant agreement to provide stock so that the company would have shares available to sell to raise needed additional capital (Pet. 16a–18a). However, at the time of the redemption the corporation had no commitment to sell the redeemed shares (Pet. 27a). The company was authorized to issue 500 shares, and could have satisfied its need for capital by the sale of authorized but unissued shares (Pet. 18a). The evidence is that no consideration was given to the authorized but unissued stock by either the company's lawyer, who had incorporated the company and acted as its counsel for the entire period between its organization and the date of the redemption, or by Mr. Neff, who was one of the incorporators of the company and had been its dominant officer and stockholder throughout its history (Pet. 17a–18a).

In the period between five and fifteen months after the redemption, the company sold 38 of the 47 shares of stock it acquired from Mr. Neff. As a result of these sales, Mr. Neff's proportionate interest in the company was materially changed (Pet. 19a).

The Court of Claims held (Pet. 11a–29a) that the $19,035 received by Mr. Neff on the redemption of 47 shares of his stock was a distribution essentially equivalent to a dividend and therefore taxable as ordinary income, rather than as capital gain, under Section 302 of the Internal Revenue Code of 1954. Judge Laramore dissented (Pet. 29a–32a).

ARGUMENT

The court correctly applied the law to the particular facts of this case. There is no conflict of decisions and no cause for review.

The taxpayer, essentially the sole owner of a corporation (Pet. 27a), received a distribution of $19,035 in redemption of approximately one-half his share holdings. The redemption left his ownership interest virtually unchanged. The sole question presented is whether the distribution was essentially equivalent to a dividend and therefore taxable as ordinary income under Section 302(b)(1) of the Internal Revenue Code of 1954. The answer turns upon the facts and circumstances of the case (see Treasury Regulations on Income Tax (1954 Code), Section 1.302–2(b), *supra*, p. 4; S. Rep. No. 1622, 83d Cong., 2d Sess., p. 233 (3 U.S.C. Cong. & Adm. News (1954) 4621, 4870, quoted in the petition at page 8), and these were properly assessed by the court below.

The taxpayers complain that the corporation had a valid business purpose for redeeming the stock and for that reason the distribution should have been treated as a sale rather than a dividend. They refer to the corporation's need to raise additional capital

and the plan to sell the shares obtained from the taxpayer. The court, although acknowledging the existence of the need, properly held that it did not convert this distribution from a dividend to a sale. See *Holsey* v. *Commissioner*, 258 F. 2d 865, 869 (C.A. 3); *Northup* v. *United States*, 240 F. 2d 304, 307 (C.A. 2). In any event, the court found that the redemption "was devoid of any * * * real relationship" to the corporate need for additional capital. Its finding is amply supported by facts. Thus, even assuming a desire not to increase the number of outstanding shares of stock, the same corporate purpose could have been achieved without any payment to the taxpayer—Mr. Neff could have turned in one-half of his shares for subsequent sale by the corporation.

There is no merit to taxpayers' argument that the Court of Claims improperly looked to the taxpayer's interest in the corporation immediately before and immediately after the distribution (Pet. 6–7). These facts may be pertinent to a determination whether a distribution is a substantially disproportionate redemption entitled to capital gains treatment under Section 302(b)(2). There is, however, no bar to considering the same facts when determining whether a distribution was essentially equivalent to a dividend under Section 302(b)(1).[1] Neither *United States* v. *Carey*, 289 F. 2d 531, 535 (C.A. 8) nor *Radnitz* v. *United States*, 187 F. Supp. 952, 956 (S.D. N.Y), is

[1] The short answer to taxpayers' contention that the court should have recognized the corporation's subsequent sale of the shares some five to fifteen months after their redemption to be part of the original transaction, is that the court's holding to the contrary is amply supported by the facts.

to the contrary (Pet. 6–7). These cases do not hold that the court, in determining whether a distribution is essentially equivalent to a dividend under Section 302(b)(1), must disregard the taxpayers' ownership interest immediately before and after the redemption. Rather, they merely restate Section 302(b)(5) which provides that the fact that a redemption fails to qualify under the specific exceptions in Subsections (2), (3) and (4) shall not preclude a finding that the redemption is entitled to capital gains treatment under Subsection (1). Neither *Carey* nor *Radnitz* holds that the court must blind itself to all the facts that would be pertinent under those subsections when proceeding under Section 302(b)(1).

There is no merit to the taxpayers' other contentions. Other decisions cited by taxpayers, *Commissioner* v. *Snite,* 177 F. 2d 819 (C.A. 7); *Decker* v. *Commissioner,* 32 T.C. 326, affirmed on the Tax Court's findings and opinion, 286 F. 2d 427 (C.A. 6); and *Smith* v. *United States,* 130 F. Supp. 586 (C. Cl.), are distinguishable on their facts.

CONCLUSION

For the reasons stated, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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